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in Mortgage Loan  
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TERESA OLCOTT COHEA  
LEGISLATIVE FISCAL ANALYST

STATE OF MONTANA

*Office of the Legislative Fiscal Analyst*

STATE CAPITOL  
HELENA, MONTANA 59620  
406/444-2986

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TO: Legislative Finance Committee

FROM: Teresa Olcott Cohea  
Legislative Finance Committee

RE: State Investment in Mortgage Loan Servicing Company

## INTRODUCTION

In August, the Board of Investments entered into a limited partnership with America's Lending Network (ALN) to purchase mortgaging servicing rights for residential mortgages. Under the terms of the limited partnership agreement, the board will invest up to \$25 million of funds from the Teachers' Retirement and Public Employees Retirement systems in the partnership by 1995. The limited partnership is in effect until 2021, with the board projected to provide 99 percent of the capital (\$25 million) and ALN 1 percent (\$1,000).

As a condition of the agreement, ALN must maintain its principal office and place of business in Montana. Standard Federal Savings Bank, a savings bank headquartered in Maryland that is the parent company of ALN, has agreed to open a mortgage servicing facility in Montana and provide approximately \$5 million of capitalization and start-up funding. ALN estimates that the facility will employ about 75 people initially and as many as 300 by 1995. It is currently evaluating possible locations in several Montana cities and hopes to announce its intended site in mid-September.

Several committee members have expressed interest in learning more about this sizeable new investment of retirement funds. Dave Lewis, the Executive Director of the Board of Investments, will make a presentation at the committee's September 9 meeting. Following is some general background information on the investment.

## LOAN SERVICING

Typically, loan servicing includes monthly billing, escrow accounting, and collection. Many financial institutions contract with loan servicers for these services, rather than performing such administrative functions themselves. Typically, interest rates charged for loans include a half-point of interest for servicing costs. Loan servicers buy the "right" to service loans, thus collecting the additional interest. Generally, the loan servicer does not hold an interest in the real or personal property involved in the loan; rather, his liability is limited to performing the required services. If a loan is delinquent or is foreclosed, the loan servicer does not have a credit risk. However, the loan servicer may have to prepay foreclosure costs, which are generally reimbursed by the lender when the foreclosure action is completed.

Standard Federal Savings Bank, a federally chartered savings bank headquartered in Maryland, is one of the top five loan servicers in the nation, offering loan servicing and subservicing for all types of loans. In May 1991, the bank was servicing 600,000 loans totalling more than \$29 billion.

Due to federal legislation passed in 1988, Standard Federal Savings Bank--like many other financial institutions--is required to increase its capital. The bank has filed a capital restoration plan with the Office of Thrift Supervision, which gave its conditional approval of the plan in

September 1990 and issued a Certificate of Good Standing for the bank in March 1991. Under the plan, the bank must meet interim capital targets and reach the required capital level by December 1994.

In order to help achieve its capitalization goals, the bank has proposed that the Board of Investments invest in a limited partnership which will purchase "packages" of mortgage loan servicing rights. The board will then contract with the bank to service these loans. Under this arrangement, the board--rather than the bank--will furnish the capital to purchase loan servicing packages. The board and the bank will then split the fees earned from the loan servicing.

## TERMS OF THE LIMITED PARTNERSHIP

Based on the recommendation of bank experts and legal counsel, the board required Standard Federal Savings Bank to create a separate company--America's Lending Network (ALN)--to ensure that the board is not liable for any transactions of the Standard Federal Savings Bank. The board has entered into the limited partnership agreement with ALN for the primary purpose of purchasing mortgage servicing rights on residential mortgages. The limited partnership agreement is a detailed document (45 pages) designed to enumerate and limit the board's liabilities.

Under this agreement, the board will invest retirement funds in the partnership according to the following schedule:

\$5 million when the agreement is signed

\$5 million on September 1, 1992

\$5 million on September 1, 1993

\$5 million on September 1, 1994

\$5 million on September 1, 1995



ALN is not required to invest any funds beyond the original \$1,000 in the partnership. It performs all the administrative functions involved in mortgage servicing. These expenses are deducted from the portion of the mortgage payment that is made for loan servicing. The net earnings are then distributed 99 percent to the board and 1 percent to ALN.

The board's Chief Investment Officer says that he anticipates a 15 percent annual rate of return on investments, under current market conditions. However, a specific rate of return was not included in the agreement, since changing mortgage interest rates and the market for loan servicing rights affect the return.

Board staff emphasize that under the terms of the agreement the board is not obligated to meet the investment schedule. Section 3.02(c) of the agreement provides:

...the [board] is not required to make an additional capital contribution or installments thereof if the past return or future estimated return on its capital contribution is deemed insufficient by the [board].

Based on this provision, board staff and legal counsel say that the board is not required to invest any funds with ALN. ALN staff have agreed in letters and discussions to allow board staff to review all "packages" of mortgage servicing rights before it invests funds in the limited partnership. Board staff can reject the packages if the "past return or future estimated return" is deemed "insufficient".

A question can be raised whether the board is in fact required under the agreement to make the initial \$5 million investment. Section 3.02(a) requires the board to invest \$5 million on the "admission date". Section 3.02(c) allows the board to refuse to make "additional" investments, which are defined in the agreement as capital contributions made "subsequent to the admission date". Board staff argue that despite this language, it is

clear from discussions with ALN that the board is not required to make any investment and will review all "packages" before it agrees to purchase.

As a practical matter, the board has not yet invested the \$5 million. The certificate of limited partnership (required under Montana law) is still being drafted. The board's Chief Investment Officer has told ALN staff that he will not invest any funds in the limited partnership until: 1) ALN has signed a building lease in Montana for its mortgage servicing facility; and 2) board staff have examined the quality and anticipated rate of return on the "packages" of mortgage servicing rights that would be purchased with the retirement funds.

Staff also note that the board does not intend to invest funds in or have any liability for the mortgages themselves. It will hold an interest only in the right to service those mortgages. Staff say the chief risk of the investment is that mortgages will be prepaid or be foreclosed, thus ending the need for servicing and the associated servicing fees. In a loan foreclosure, the board and ALN will have to prepay foreclosure costs (as the board does now on other mortgages it holds), but anticipates that it will receive reimbursement from the lender when the foreclosure action is completed.

The terms of the agreement do not prohibit either ALN or the board from acquiring an interest in the mortgage itself; it states only that the "primary" purpose of the limited partnership is to purchase interests in mortgage servicing rights. However, board staff says that under the terms of section 3.02(c) they can refuse to participate in any investments that involve interests in the real property itself.

While board staff feel that the potential risks of the investment are few, the limited partnership agreement does state:

Section 3.04, the board may have to return previous earnings it received under the agreement "if the partnership does not have sufficient assets to discharge liabilities to its creditors"

Section 4.02. In the event of a dissolution of the partnership, ALN has first call on the remaining income and the board a secondary position. However, losses arising in connection with a dissolution are allocated 99 percent to the board and 1 percent to ALN.

Board counsel and staff state that these provisions are required under Montana law and federal tax regulations.

## BOARD ASSESSMENT OF INVESTMENT

Board staff believe that the limited partnership with ALN offers high return (approximately 15 percent) under current market conditions with relatively little risk. They state that mortgage loan servicing is a good cash "hedge" for investors who hold long-term fixed-rate assets, since servicing rights investments increase in value when interest rates go up due to the slowdown in refinancing and mortgage loan payoffs. Conversely, long-term fixed rate investments (such as bonds) decline in value as interest rates increase. Board staff believe that mortgage loan servicing is a good investment in the current market, since mortgage rates are at a relatively low level.

While loan servicing rights are generally a long-term investment (20 to 30 years), board staff say there is a ready market for these rights and they would anticipate no difficulty in the partnership's divesting itself of the investment if it chose.

Board staff evaluated Standard Federal Bank's proposal for over six months before recommending that the board sign the limited partnership agreement. They commissioned a "due diligence" study by a long-time Montana banker and former state Commissioner of Financial Institutions. The board's Chief Investment Officer travelled to Maryland to review the bank's operations. The board's counsel has spent significant time reviewing the



terms of the limited partnership agreement and the certificate of partnership.



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